

Franchise Tax Board**ANALYSIS OF ORIGINAL BILL**Author: DeVore Analyst: John Pavalasky Bill Number: AB 1937Related Bills: _____ Telephone: 845-4335 Introduced Date: February 1, 2006Attorney: Patrick Kusiak Sponsor: _____**SUBJECT:** Conformity to Federal Exclusion for Federal Prescription Drug Plan Subsidy Payments**SUMMARY**

This bill would, in conformity with federal income tax law, exclude from California tax any federal subsidy payments made to employers that provide a qualified prescription drug plan to the retirees of that employer.

PURPOSE OF THE BILL

According to the author's office, the purpose of the bill is to conform to the federal tax treatment of these federal subsidy payments to create more uniformity and consistency between California and federal law.

EFFECTIVE/OPERATIVE DATE

This bill would be effective immediately and apply to taxable years beginning on or after January 1, 2006.

POSITION

Pending.

ANALYSISFEDERAL/STATE LAWCURRENT FEDERAL LAW

On December 8, 2003, the President signed the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (PL 108-173). Among other provisions that mandated a new Part D Prescription Drug Coverage beginning in 2006, that act amended the Social Security Act (SSA) and the Internal Revenue Code (IRC) relating to the payment of federal subsidies to certain employers.

The conference report for PL 108-73 contains the following statement regarding the reason for the federal subsidies:

Board Position:

<input type="checkbox"/> S	<input type="checkbox"/> NA	<input type="checkbox"/> NP
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<input type="checkbox"/> N	<input type="checkbox"/> OUA	<input checked="" type="checkbox"/> PENDING

Department Director

Date

S. Stanislaus

3/13/06

“About one-third of Medicare beneficiaries receive coverage for prescription drugs from their former employers. Retirees are generally happy with their coverage and want to keep it. But employer plans are under increasing pressure to drop or scale back coverage. In 1988, 66% of large employers provided health benefits. In 2002, that number slipped to just 34%. Costs for retiree health coverage rose 16.0% in 2002, while prescription drug expenditures increased by 11.8% last year, and most employers predict double-digit health inflation well into the future. Conferees believe the employer retiree subsidies included in the conference report will help employers retain and enhance their prescription drug coverage so that the current erosion in coverage would plateau or even improve. Absent this assistance, many more retirees will lose their employer sponsored coverage.”

1. Federal subsidy payments (SSA section 1860D-22)

Section 101 of PL 108-173 amended the SSA to add section 1860D–22, establishing special rules for employer-sponsored programs. Under certain conditions, the Secretary of Health and Human Services (Secretary) is required to make special subsidy payments to sponsors of qualified retiree prescription drug plans, as defined. These payments are to be made on behalf of an individual covered under the retiree plan, entitled to enroll under a prescription drug plan (PDP), or MA–PD plan but elected not to.

Subsidy payments equal 28% of gross covered retiree plan-related prescription drug costs greater than \$250 but not greater than \$5,000, adjusted annually by the percentage increase in Medicare per capita prescription drug costs.

Qualified retiree prescription drug plans must be employment-based group health plans. Group health plans include welfare plans defined under the Employee Retirement Income Security Act of 1974 (ERISA), federal and state governmental plans, including such plans as the Federal Employee Health Benefits program and CalPERS, collectively bargained plans, and church plans. The conference agreement specifically states that the conferees expect that in the case of interpretive matters with regard to plan sponsors of group health plans, Centers for Medicare & Medicaid Services (CMS) will coordinate with the Department of Labor and Treasury Department for guidance.

The sponsor must provide the Secretary with an attestation that the actuarial value of prescription drug coverage under the plan is at least equivalent to the actuarial value of standard prescription drug coverage. The sponsor, or administrator designated by the sponsor, shall maintain and afford the Secretary access to necessary records for the purpose of audits and other oversight activities. The sponsor is required to provide disclosure of information in accordance with disclosure of information on creditable coverage.

The conference agreement specifically states that nothing in the section is to be construed as precluding an individual covered under an employment-based retiree plan from enrolling in a PDP plan or MA–PD plan or having the employment-based plan from paying the premium. The PDP or MA–PD plan would constitute primary coverage, not the employer. Employment-based retiree coverage may provide coverage that is better than standard coverage to retirees under a qualified retiree prescription drug plan. Employment-based retiree health coverage may provide coverage that is supplemental to benefits provided under a prescription drug plan or MA–PD plan to enrollees in such plans.

The conference agreement also specifically states that nothing is to prevent employers from providing flexibility in benefit design and pharmacy access provisions for basic drug coverage so long as actuarial equivalence requirements are met.

2. Exclusion from gross income for federal subsidy payments (IRC sections 56 and 139A)

Section 1202 of PL 108-173 amended the IRC to add section 139A to provide that gross income does not include any special subsidy payment received under SSA section 1860D-22. The exclusion applies for purposes of both the regular tax and the alternative minimum tax (including the adjustment for adjusted current earnings (ACE) for corporations).

The statute provides that the exclusion is not taken into account in determining whether a deduction is allowable with respect to costs taken into account in determining the subsidy payment. The conference agreement specifically states:

“Accordingly, a taxpayer could claim a deduction for prescription drug expenses incurred even though the taxpayer also received an excludible subsidy related to the same expenses.”

Thus, under federal law, the deduction for retiree plan-related prescription drug costs are deductible by the employer as an ordinary and necessary business expense without being reduced by the amount of the federal subsidy payment.

CURRENT CALIFORNIA LAW

California expressly does not conform to IRC section 139A, which allows an exclusion from gross income for special subsidy payments under SSA section 1860D-22. Thus, these federal subsidy payments are fully taxable to the employer under California law both before and after the enactment of AB 115 (Stats. 2005, Ch. 691). See Program Background for a detailed explanation.

As under federal law, retiree plan-related prescription drug costs are deductible by the employer under California law as an ordinary and necessary business expense.

THIS BILL

This bill would, in conformity with federal income tax law, allow an exclusion from gross income for special subsidy payments received by employers under SSA Section 1860D-22.

The exclusion would apply for purposes of both the regular tax and the alternative minimum tax (including the adjustment for adjusted current earnings (ACE) for corporations).

This bill would, in conformity with federal income tax law, provide that the exclusion is not taken into account in determining whether a deduction is allowable with respect to costs taken into account in determining the subsidy payment.

PROGRAM BACKGROUND

Effective for taxable years ending after December 8, 2003, Act Section 1202 of the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (PL 108-173) enacted IRC section 139A that allows an exclusion from federal gross income for federal subsidies for prescription drug plans.

The Revenue and Taxation Code in California pertaining to income and franchise taxes has two separate parts. The first part contains the law regarding the taxation of non-corporate taxpayers and is called the Personal Income Tax Law (PITL). The second part contains the law regarding the taxation of corporations and is called the Corporation Tax Law (CTL).

In the case of exclusions from gross income, the PITL and the CTL are structured differently.

Under the CTL, a specific code section must affirmatively provide for the exclusion from gross income either by reference to the federal IRC section or by stand-alone language. No such code section to conform to IRC section 139A has been enacted and, thus, the federal subsidies for prescription drug plans remain fully taxable to corporations.

Under the PITL, conformity to exclusions from gross income is controlled by the "specified date." That is, prior to AB 115, California conformed to the exclusions from gross income (with specified exceptions) that were enumerated in Part III of Subchapter B of the IRC as it read on January 1, 2001. Enactment of IRC Section 139A occurred after that "specified date" and, thus, California did not conform to that exclusion from gross income under the PITL. AB 115 (Stats. 2005, Ch. 691) changed the "specified date" from January 1, 2001, to January 1, 2005, and added Section 17139.6 to provide specifically that the exclusion from gross income under IRC section 139A does not apply under the PITL. Thus, the federal subsidies for prescription drug plans remain fully taxable to non-corporate taxpayers.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws. Computation of state taxable income starts with federal adjusted gross income (AGI) for individuals or federal taxable income (TI) for corporations in each of these states.

Conforming States

Florida, Illinois, Massachusetts, Michigan, and New York do not require an adjustment to add back to state income the federal exclusion for federal subsidies for prescription drug plans and, thus, have conformed to that federal exclusion.

Non-Conforming States

Minnesota, like California, does require the amount excluded on the federal return to be added back to income and, thus, has not conformed to that federal exclusion.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

Based on data and assumptions discussed below, the PITL and CTL revenue loss from this bill would be as follows:

Estimated Revenue Impact of AB 1937 Effective for Taxable Years Beginning On or After January 1, 2006 Enactment Assumed After June 30, 2006 (\$ Millions)			
	2006-07	2007-08	2008-09
Exclude Subsidy	-\$41	-\$53	-\$59

This bill does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Revenue Discussion

The above estimates are based on a California pro-ratio of federal data. The estimates are subject to change when updated federal estimates become available.

The federal estimate for fiscal years 2006, 2007, 2008, and 2009 are losses of \$1.2 billion, \$1.7 billion, \$1.9 billion, and \$2.1 billion, respectively. However, the federal fiscal year begins on October 1st and ends on September 30th. In order to derive the estimates for the California fiscal year that begins July 1st and ends on June 30th, it first was necessary to convert the federal estimates to the taxable year. For the 2006 taxable year, that conversion contains nine months of the 2006 fiscal year loss (9/12), or \$900 million, and three months (3/12) of the 2007 fiscal year loss or \$425 million. The total federal estimated loss for taxable year 2006 is \$1.325 billion, for taxable year 2007 is \$1.750 billion, for taxable year 2008 is \$1.950 billion, and for 2009 is \$2.155 billion.

Applying a pro-ratio factor of 3% to the 2006, 2007, 2008, and 2009 taxable year federal estimates results in \$40 million, \$53 million, \$59 million, and \$65 million respectively, as the California share of the total federal taxable year estimated losses. In order to derive the cash flow California fiscal year estimates shown in the table it was assumed that 90% would come from the first taxable year estimate and 10% from the subsequent taxable year estimate to take into account a reduction in estimated tax payments. The California fiscal year impact that results (90% x \$40 million = \$36 million plus 10% x \$53 million = \$5 million) is a \$41 million loss for 2006-07, for fiscal year 2007-08 is a \$53 million loss (90% x \$53 million = \$47 million plus 10% x \$59 million = \$6 million), and for fiscal year 2008-09 is a \$59 million loss (90% x \$59 million = \$53 million plus 10% x \$65 million = \$6 million).

ARGUMENTS/POLICY CONCERNS

This bill would, in conformity with federal income tax law, provide that the exclusion is not taken into account in determining whether a deduction is allowable with respect to costs taken into account in determining the subsidy payment. Accordingly, a taxpayer could claim a deduction for prescription drug expenses incurred even though the taxpayer also received an excludible subsidy related to the same expenses. This would provide a tax benefit that equals more than 100% of the prescription drug expenses incurred by the employer. That is, full deductibility of the employer's prescription drug expenses plus the exclusion of the federal subsidy payment of 28% of those expenses ($100\% + 28\% = 128\%$).

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